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IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CENCO INCORPORATED,
Petitioner,

vs.

SEIDMAN & SEIDMAN,
Respondent.

SEIDMAN & SEIDMAN'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

Petitioner's statement of "Questions Presented" violates the direction in Supreme Court Rule 21.1(a) that "[t]he statement of the questions ... should not be argumentative...." Most of petitioner's "Questions Presented" is pure argument in both form and substance. Even the two numbered questions are improper. They are substantially infused with and dependent upon incorrect characterizations of the decision of the Court of Appeals and of the jury instructions given by the District Court, which were affirmed by the Court of Appeals. Petitioner's questions also improperly assume facts which were either determined contrary to its assumptions or else were never determined in the trial court. Accordingly, petitioner's questions violate the prescription in Rules 21.1(a) and 21.5 that questions presented for review be accurate and "expressed in the terms and circumstances of the case."

Petitioner's question No. 1 contains a false factual premise that respondent auditors "knowingly concealed their suspicions of fraud." There was no finding by either court or jury that respondent knowingly concealed, or even had, a suspicion of petitioner's fraud. All the evidence was to the contrary. Certainly, the verdicts of the jury in Seidman's favor and the directed verdicts of the District Court dismissing petitioner's conspiracy and aiding and abetting claims after trial, all affirmed by a unanimous panel of the Court of Appeals, do not support petitioner's factual assumption. A petition for certiorari is no place for reargument of facts, much less a place for introduction of misstated facts.

Contrary to another false premise on which petitioner's question No. 1 depends, neither the District Court's jury instructions nor the decision of the Court of Appeals stated, or even implied, that an auditor should be excused from liability

to its client "solely because some senior client managers were involved in [the] fraud." Both the jury instructions and the Court of Appeals decision stated that the auditor would be responsible for its own conduct. They also limited the availability to the auditor of defenses to petitioner's common law claims of negligence, breach of contract and fraud to situations in which petitioner's agents acted both within the scope of their authority and for the benefit of petitioner, Cenco Incorporated ("Cenco"). See District Court instructions and opinion of Court of Appeals. (Pet. App. D5; A6-9; A11-12).

Petitioner's question No. 2 is improper because it attempts to raise a question *de novo*, not a question for *review*. Petitioner did not argue below the issue of a need for a rule of federal common law arising from the federal securities laws. Question No. 2 appears to be a belated attempt by petitioner to smuggle a federal question into a state common law case. (Pet. App. A1, 4).

Because petitioner's question No. 1 is dependent upon both incorrect facts and a misstatement of the instructions, and its question No. 2 is not a question for *review* but an issue raised *de novo*, the petition for certiorari contains no properly presented question.

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OPINIONS BELOW

The "Opinions Below" section of the petition omits to mention that the Court of Appeals affirmed the District Court's directed verdicts at the close of trial in favor of respondent Seidman & Seidman ("Seidman") on Cenco's claims of conspiracy and aiding and abetting a fraud. (Pet. App. A5-6). Cenco's petition does not challenge those verdicts in Seidman's favor.

JURISDICTION

Cenco states that its claims against Seidman in the District Court "rested on federal question jurisdiction, 28 U. S. C. § 1331, Section 27 of the Securities Exchange Act of 1934, 15

U. S. C. § 78aa, and the principles of pendent and ancillary jurisdiction." (Pet. 2). However, as the Court of Appeals held, "these [jurisdictional] statutes are not pertinent to Cenco's cross-claims since Cenco does not allege any violation of a federal statute or rule." (Pet. App. A4).

The Cenco litigation was initiated by Cenco stockholders who filed class action complaints under the federal securities laws and state common law against Cenco, its board of directors, members of Cenco's management and Seidman. Initially, Cenco's cross-claims against Seidman included claims for contribution and indemnity under the federal securities laws, but these claims were dismissed by the District Court. Cenco did not appeal from the dismissal of its indemnification claim and dropped its appeal in the Court of Appeals from the dismissal of its contribution claim. (Cenco br. 66, n. 57). The remainder of Cenco's cross-claims were purely state common law claims, federal court jurisdiction over which was based on principles of pendent and ancillary jurisdiction. (Pet. App. A4). Cenco's pendent state common law claims of negligence, breach of contract and fraud are the only claims by Cenco which are the subject of its petition for certiorari. The Court of Appeals found that these claims were governed by the common law of Illinois. (Pet. App. A1-4).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations claimed by Cenco to be involved in the case are afterthoughts. (See Pet. 2, "Statutes and Regulations Involved"). None was ever cited, let alone argued, by Cenco in the District Court or the Court of Appeals. (See copies of the relevant sections of the tables of authorities in Cenco's principal and reply briefs in the Court of Appeals, Resp. App. A). In the District Court, Cenco never argued that either a federal statute or federal common law should deter-

mine Cenco's claims of negligence, breach of contract and fraud. Further, Cenco never objected to any jury instruction, or the failure to give an instruction, on the ground that any federal statute or regulation was applicable or that federal common law should be created and applied. Thus, there are no federal statutes, regulations or issues involved herein.

STATEMENT OF THE CASE

In its "Statement of the Case," Cenco reargues and misstates the facts in the trial record and commingles its eclectic selection of facts with its own contentions which were unsuccessful below. Cenco also omits facts which are essential to a balanced presentation of the "Statement of the Case" as contemplated by Supreme Court Rule 21.1(g). We shall limit ourselves to supplying only significant facts omitted and to correcting some of the unjustified liberties Cenco has taken with the record.

Cenco initiated its fraud in 1970. The purpose was to enhance the earnings of the company through inflation of inventory and sales and thereby cause the market price of Cenco stock to rise. As stated by the Court of Appeals:

> "The inflated stock was used to buy up other companies on the cheap. Cenco further benefited from the fraud by being able to borrow money at lower rates than if its inventories had been honestly stated and by getting its insurers to pay inflated claims for inventory lost or destroyed. . . . " (Pet. App. A2).

The Court of Appeals held that the Cenco fraud was perpetrated for the benefit of the company. (Pet. App. A11-12). Petitioner does not contest that holding.[1] During the period of the fraud, Cenco made twenty acquisitions, for which it paid one million shares of its own stock at an average price of $40 per share. (SX465; Vol. 11, Tr. 2447-53). From the time

[1] The petition does not challenge any factual determination by the courts below.

the fraud was uncovered in 1975 to the date of trial in the District Court, Cenco stock never traded above $10 per share. Thus, Cenco made an illegal profit of approximately $30 million on acquisitions alone through its fraud. (Vol. 11, Tr. 2457-58; Vol. 14, Tr. 3094).

Cenco also twice submitted fraudulent fire loss claims as a result of which the company made illegal gains at the expense of Cenco's insurance companies. The Court of Appeals' description of petitioner as "an engine of theft against outsiders—creditors, prospective stockholders, insurers, etc." is an inescapable conclusion from the seven-week trial record in this case.[2] (See Pet. App. A8).

The Cenco fraud "permeate[d] the top management of the company," (Pet. App. A8, 12). It involved participation by substantially all of Cenco's top management, including the Cenco chairman of the board, Cenco's president, the president of CMH, Cenco's principal subsidiary involved in the fraud, various vice-presidents and chief financial officers of Cenco and CMH, and CMH's national operations and sales managers. In addition, various CMH branch managers were involved, as were secretaries and other Cenco employees. (Vol. 19, Tr. 3961-65, 3983-86, 3993-96, 4003, 4007-09; Vol. 20, Tr. 4359-74, 4388-89; Vol. 21, Tr. 4461-70).

Moreover, the entire Cenco board was found by the Court of Appeals to have been one "on which dishonesty and carelessness were well represented—[the board members] were slipshod in their oversight. . . ." (Pet. App. All). As the Court of Appeals stated:

> "[T]he scale of the fraud—the number and high rank of the managers involved—both complicated the task of discovery for Seidman and makes the failure of oversight by Cenco's shareholders and board of directors harder to condone." (Pet. App. All).

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[2] The illegal fruits of Cenco's fraud redounded to the benefit of the entire corporation, including, of course, the then-existing stockholders of Cenco. (Pet.App. A 12).

The immediate target of the fraud, and one of the primary victims, was Seidman. (Vol. 19, Tr. 3960). It was vital to Cenco's scheme that the auditors be deceived. Accordingly, the fraud was accomplished through inflation of inventory at CMH branches which were not among those randomly sampled by Seidman; by moving inventory from branch to branch without the knowledge of the auditors so that it would be counted twice; through skillful fabrication, falsification and alteration of invoices, purchase orders, receiving documents and other audit documentation; as well as through false written and oral representations by numerous Cenco officers and employees to Seidman personnel. (Vol. 3, Tr. 568-69; Vol. 18, Tr. 3706-55; Vol. 19, Tr. 3966-69, 3974-77, 3982-86, 4000-06; Vol. 21, Tr. 4533-44; Vol. 24, Tr. 5199-5202).

All witnesses who testified at trial on the subject, including Cenco management-level employees who participated in the fraud, testified that deception of Seidman continued up until the scheme was uncovered in mid-1975 and that they believed that Seidman had been successfully deceived throughout the period of the fraud. Even Cenco's general counsel, Case, a key Cenco witness at trial on whom Cenco relies in its petition (Pet. 5), testified that he did not believe that Seidman was involved in the fraud or in Cenco's attempt to cover up the fraud. (Vol. 14, Tr. 3104, 3165).

A collusive fraud such as Cenco's is very difficult for an auditor to detect. Cenco's auditing expert at trial admitted that there is no assurance that collusive fraud can be detected. (Vol. 16, Tr. 3543). The "Statement on Auditing Standards" ("SAS") § 320.34 (Resp. App. B), states that collusive management fraud can circumvent audit procedures. SAS § 110.06 states:

> "... If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed,

because items such as unrecorded transactions, forgeries, *and collusive fraud would not necessarily be uncovered. . . .*" (emphasis added) (Resp. App. B).

Cenco's contention that Seidman suspected the inventory fraud is without foundation and based upon manipulation of the record. The evidence showed that early in 1975, Cenco became fearful that its inventory inflation might be discovered. In order to cover up the fraud, Cenco announced to its auditors that Cenco would embark on a program of switching from FIFO to LIFO accounting, would write down certain accounts receivable and would destroy several million dollars of obsolete inventory. Later Cenco corrected that description and claimed that the inventory was not obsolete but was substantially overstocked. (Vol. 11, Tr. 2295-97, 2306-18; Vol. 13, Tr. 2915-19). Cenco explained to the auditors that the reason for the program, including the destruction of the inventory, was that the anticipated tax benefits and savings in warehousing and related expenses would outweigh the loss engendered by the destruction. Seidman expressed doubt about the availability of the tax benefits, but Cenco stated that it was using another accounting firm, Price Waterhouse, as tax consultant. (Vol. 14, Tr. 3073-74, 3160-62).

Seidman, over the violent objections of Cenco's management and Case, insisted on an immediate press release announcing the program and forced Cenco to issue a public statement. Seidman also insisted upon a special review of the prior years' financial statements in order to be sure that a substantial amount of the inventory slated for destruction was not obsolete in prior years; otherwise, Seidman might have had to withdraw its opinions on Cenco's financial statements for those prior years. (PX205-PX207; SX264; Vol. 14, Tr. 3104, 3113, 3157).

REASONS FOR DENYING THE WRIT

I. ALL DETERMINATIONS IN THE COURTS BELOW HAVE BEEN UNANIMOUS

The issues in this case have already been determined by a District Judge, a unanimous jury of twelve persons[4] and a unanimous panel of three judges of the Court of Appeals for the Seventh Circuit. Also, Cenco's petition for rehearing *en banc* was denied by all the active judges of the Seventh Circuit.

II. THERE ARE NO PROPERLY PRESENTED QUESTIONS FOR REVIEW

Supreme Court Rule 21.1(a) requires that questions presented for review in a petition for certiorari be "expressed in the terms and circumstances of the case" and "should not be argumentative," and Rule 21.5 states that "[t]he failure of a petitioner to present with accuracy, brevity and clearness whatever is essential to a ready and adequate understanding of the points requiring consideration will be a sufficient reason for denying his petition."

Cenco's "Questions Presented" violate both Rule 21.1(a) and Rule 21.5. They are argumentative and not clearly stated, and they depend upon assumptions of fact contrary to the record and mischaracterization of the jury instructions approved by the Court of Appeals. (See, *supra*, "Questions Presented," i, ii). Accordingly, Cenco's petition should be denied.

III. THE DECISION OF THE COURT OF APPEALS DOES NOT CONFLICT WITH A DECISION OF ANY OTHER COURT

The decision of the Court of Appeals is not in conflict with any decision of this Court, any other federal court or any state court. Cenco cannot now claim that there is such a conflict,

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[4] By consent of the parties and the District Court, a jury of twelve, rather than six, rendered the verdicts.

because it contended repeatedly in the Court of Appeals that the issue involved in the instant case was "of first impression" (Cenco br. 30-1; Cenco reply br. 2), and that its appeal "presents a question of law never previously confronted by an American court." (Cenco br. 27). The Court of Appeals, too, said that "the question has never been the subject of a reported case." (Pet. App. A9).

Recognizing the importance of showing in its petition for certiorari that the decision of the Court of Appeals herein conflicts with prior decisions of this Court or of any other Court of Appeals, Cenco now argues that the decision below does conflict with the decisions of other federal courts. Cenco's argument is without merit.

The Court of Appeals in this case decided only what defenses an auditor has to claims by its corporate client of negligence, breach of contract and fraud under the common law of Illinois, where corporate fraud permeates top management of the corporation, is committed for the benefit of the corporation and injures outsiders. The decision of the Court of Appeals was expressly limited to these issues and circumstances. The court was not declaring a universal rule of agency, let alone a general agency rule applicable to all auditor-client cases. It was not even declaring a universal agency rule covering auditor-client cases *in Illinois*. Thus, the court stated:

> "We need not go so far as to predict that the Illinois courts would hold that in any action by a corporation against its auditors an employee's fraud intended to benefit the company rather than the employee at the company's expense will be attributed to the corporation, . . . [W]e think it premature as well as unnecessary to decide that an auditor is never liable for the frauds of loyal but misguided company employees that he could have prevented by taking care. But here the uncontested facts show fraud permeating the top management of Cenco. In such a case the corporation should not be allowed to shift the entire responsibility for the fraud to its auditors.

"Hence the challenged jury instruction was proper in the circumstances. . . ." (Pet. App. A12).

Cenco cites no auditor-client liability case as allegedly in conflict with the decision of the Court of Appeals in this case. Indeed, in its appeal brief in the Court of Appeals, Cenco stated, "The accountants' liability cases have never addressed or resolved the applicability of agency-imputation principles." (Cenco reply br. 41). Because of Cenco's admissions and because, as we shall demonstrate, the cases Cenco cites in its petition do not involve the auditor-client issues involved in the instant case, Cenco cannot meet the Supreme Court Rule 17 standard of showing a conflict between the decision of the Court of Appeals herein and a decision of this Court or any other federal court. As stated in Stern and Gressman, *Supreme Court Practice*, 5th ed., 1978, in referring to former Rule 19, which in substance is the present Rule 17, "[a] true conflict, in other words, must be direct and irreconcilable, and must be demonstrably so," and "there must be a real conflict on the same matter of law or fact, not merely an inconsistency in dicta or in the general principles utilized." (at 273 and 264).

Unable to cite any case on auditor liability in conflict with the Court of Appeals decision, petitioner reaches far afield to cite five stockholder derivative cases and one case brought by the liquidators of an investment trust, all involving allegations of violation by corporate directors or officers of their fiduciary duties and of Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Rule 10b-5 thereunder.[5] (Pet. 16-17). Petitioner's contention that the Court of Appeals'

[5] The suit by the trustees is *IIT, An International Invest. Trust* v. *Cornfeld*, 619 F.2d 909 (2d Cir. 1980) (Pet. 16-17). The derivative cases are *Alabama Farm Bureau Mutual Casualty Co.* v. *American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979), *cert. denied* 449 U. S. 820 (1980); *Maldonado* v. *Flynn*, 597 F.2d 789 (2d Cir. 1979); *Goldberg* v. *Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied* 434 U. S. 1069 (1978); *Shell* v. *Hensley*, 430 F.2d 819 (5th Cir. 1970); *Schoenbaum* v. *Firstbrook*, 405 F. 2d 200, *vacated* 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied* 395 U. S. 906 (1969).

affirmance of the jury instructions in the instant case conflicts with the holdings in the 10b-5 cases is without merit. Those 10b-5 decisions involve totally different subject matters and issues.

The 10b-5 cases cited by Cenco involved suits by innocent parties alleging fraud in the purchase and sale of securities and breaches of fiduciary duty by management employees, and in some cases their co-conspirators, who were defrauding their own companies by means such as looting. Rule 10b-5 is not involved herein. Further, Cenco does not claim that Seidman either had or breached a fiduciary duty, and in the instant case there is a final determination that Seidman was not a co-conspirator. (Pet. App. A3-6). Obviously, a rule precluding an unfaithful agent from defending against a suit by his corporation on the ground that his acts were attributable to the corporation is not inconsistent with the jury instruction herein holding Cenco responsible to independent third parties for acts of its management which were committed for the purpose of benefiting Cenco at the expense of third parties.

The District Court's agency instruction herein permitted attribution of the fraudulent acts of management to the corporation only if those acts were committed with the intention of benefiting the company. (Pet. App. A11). The Court of Appeals, in affirming the District Court's instruction, emphasized the distinction between fraud committed on behalf of a corporation and fraud committed against a corporation, stating:

> "Fraud on behalf of a corporation is not the same thing as fraud against it. . . . [T]he primary costs of a fraud on the corporation's behalf are borne not by the stockholders but by outsiders to the corporation, and the stockholders should not be allowed to escape all responsibility for such a fraud. . . ." (Pet. App. A12).

Since in each of the 10b-5 cases cited by Cenco, management's fraud was committed *against* the corporation by its own agents, the jury instruction herein approved by the Court of Appeals would have no applicability to those 10b-5 cases, and the decision of the Court of Appeals cannot be in conflict with them.

The only other federal court decision which Cenco alleges is in conflict with the Court of Appeals decision is *Mutual Life Ins. Co. v. Hilton-Green*, 241 U. S. 613 (1916). *Mutual Life* is not in conflict with the Seventh Circuit's decision herein. The subject matters of the two cases are entirely different. *Mutual Life* did not involve any auditor-client issue; nor did it involve Illinois law. The decision was merely that where an insured procured an insurance policy by fraudulent means and where the insurance company's agent knew of the fraud, the insured's beneficiaries could not defeat the insurer's defense that the fraudulently acquired policy was void by arguing that the insurer's agent's knowledge of the fraud should be attributed to his principal. *Mutual Life* is also distinguishable in that the fraud in that case was not by management and was *against* the company, whereas in the instant case, the fraud was committed by management against outsiders for the benefit of the company.

The only case mentioned anywhere in the petition which rules on a claim by a client against an auditor, *Cereal Byproducts Co.* v. *Hall*, 8 Ill. App. 2d 331, 132 N. E. 2d 27 (1956), *aff'd*, 15 Ill. 2d 313, 155 N. E. 2d 14 (1958), was properly held by the Court of Appeals to be inapplicable. Cenco's petition does not dispute that conclusion. In fact, Cenco has not contended that the Court of Appeals decision incorrectly determined Illinois law or is in conflict with Illinois law. In *Cereal Byproducts*, a single, low-level, non-managerial employee had issued a directive to the auditors that they should not verify certain accounts receivable. The court held there was no basis for the auditors' belief that issuance of such a directive to the auditors was within the scope of that employee's authority, and that under the circumstances, the auditor had no right to rely on the employee's directive. Also, the fraud in *Cereal Byproducts* was an embezzlement fraud by the employee *against* his company; not, as in the instant case, a fraud for the benefit of his company. The Court of Appeals, therefore, said of *Cereal Byproducts* in holding it inapplicable:

> "But this does not tell us what the result should be if the fraud permeates the top management of the company and if, moreover, the managers are not stealing from the company—that is, from its current stockholders—but instead are turning the company into an engine of theft against outsiders—creditors, prospective stockholders, insurers, etc. On this question the Illinois cases on auditors' liability provide no guidance." (Pet. App. A8).

Contrary to what Cenco argues, the Court of Appeals did not apply agency law "indiscriminately" in the instant case. (Pet. 16). For example, the Court of Appeals held that *Cereal Byproducts* precluded a rule automatically exonerating auditors from all liability when they fail to detect an employee's fraud, stating that *Cereal Byproducts* does not permit automatic attribution of employees' fraud to the corporation in all situations. Further, the Court of Appeals carefully explained why it affirmed the District Court's agency instructions, and based on its reasoned analysis, it held that the instruction was "proper in the circumstances" of this case. (Pet. App. A12).

It is clear from the foregoing that the decision of the Court of Appeals does not conflict with any federal or state court decision.[6]

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[6] Although the Court of Appeals stated that there are no state or federal precedents on the precise issue involved in the instant case, there are a number of analogous state court and federal district court decisions in negligence and breach of contract suits by clients against their auditors in which the courts ruled that auditors had defenses to such actions if the clients' agents interfered with the auditors' performance of their audits. In those cases, obviously, the acts of the agents were attributed to their employers. See *Republic Nat. Life Ins. Co.* v. *Beasley*, 73 F. R. D. 658 (S. D. N. Y. 1977); *National Surety Corp.* v. *Lybrand*, 256 App. Div. 226, 9 N. Y. S. 2d 554, 563 (Sup. Ct. 1939); and *Delmar Vineyard* v. *Timmons*, 486 S. W. 2d 914 (C. A. Tenn. E. S. 1972). See also *Falkenberg* v. *Baldwin*, CCH Fed. Sec. L. Rpts. ¶ 96,086, at 91,909 (S. D. N. Y. 1977) and *Social Security Admin. Baltimore F.C.U.* v. *U.S.*, 138 F. Supp. 639 (D. Md. 1956).

IV. PETITIONER'S UNTIMELY CONTENTION THAT THE COURT OF APPEALS SHOULD HAVE CREATED AND APPLIED FEDERAL COMMON LAW WAS PROPERLY REJECTED

Cenco's petition for certiorari relies heavily on its belated contention, argued for the first time in its petition, that the Court of Appeals should have created a new principle of federal common law, rather than apply state common law. That contention is without merit, because petitioner did not timely argue the federal common law issue and because even if that issue had been argued below, federal common law would not be applicable to the issues herein. In any event, a newly created federal common law rule would not result in a different decision than was reached by the Court of Appeals under Illinois common law.

The federal common law issue raised in the petition had never been referred to, let alone argued, in the District Court. It was not argued in the Court of Appeals, where Cenco mentioned the subject casually in only one sentence in its 68-page reply brief, after a 75-page principal brief which was silent on the subject. That sentence is as follows:

> "This court should declare a federal rule which protects the interests of all who depend on the auditor's contract. *Cf. Illinois v. City of Milwaukee*, 406 U.S. 91, 101-08 (1972)." (Cenco reply br. 49).

This undeveloped sentence in Cenco's reply brief can hardly be deemed argument or timely raising of the issue of the applicability of federal common law. Cenco did not even state why federal rather than state common law should apply or what the content of a newly-created common law principle should be. Moreover, Seidman had no opportunity to respond to that single sentence, since it was in Cenco's reply brief.

Because Cenco had not even mentioned federal common law in the trial court or in its notice of appeal in the Court of Appeals (Resp. App. D), the latter court could properly have

refused to comment on that single sentence in Cenco's reply brief. See *Stern* v. *U. S. Gypsum*, 547 F. 2d 1329 (7th Cir. 1977), *cert. denied* 434 U. S. 975 (1977). In that case, the Court of Appeals stated:

> "It is a well-settled general proposition that a litigant cannot present to this court as a ground for reversal an issue which was not presented to the trial court and which it, therefore, had no opportunity to decide. [citations omitted.]".

547 F. 2d at 1333. In the instant case, therefore, the Court of Appeals properly stated:

> "One sentence in Cenco's reply brief in this court, citing an interstate pollution case, asks us to create a rule of federal common law to govern auditors' liabilities, but we decline so casual an invitation to so ambitious an exercise of judicial creativity." (Pet. App. A4).

Not only was Cenco's federal common law argument not properly raised below, but the statutes and rules relied upon in the petition likewise were not cited in either court below. (See p. 2, *supra.*)

This Court has frequently held that it will not consider the merits of an issue raised for the first time in the Supreme Court. In *Miree* v. *DeKalb County*, 433 U. S. 25 (1977), one of petitioner's arguments was that the Airport and Airway Development Act of 1970 provided an implied civil right of action for injury due to violation of the Act. However, this Court noted that there was no indication that a violation of this statute had been alleged below. Accordingly, it refused to consider the issue, using language which fits Cenco's attempt herein to argue a federal common law issue for the first time in its petition for certiorari. This Court stated in *Miree:*

> "The fact that this asserted basis of liability is so obviously an afterthought may be some indication of its merit, but since it was neither pleaded, argued, nor briefed either in the District Court or in the Court of Appeals, we will not consider it."

433 U. S. at 33-4. To the same effect see *NLRB* v. *Sears, Roebuck & Co.*, 421 U. S. 132, 163-5 (1975); *Tacon* v. *Arizona*, 410 U. S. 351 (1973); *Tyrrell* v. *District of Columbia*, 243 U. S. 1, 4, 6 (1917); *Ramsey* v. *Mine Workers*, 401 U. S. 302, 312 (1971); and *Husty* v. *United States*, 282 U. S. 694, 701-02 (1931).

Not only did Cenco fail adequately to raise an issue as to federal common law in the courts below, but its principal brief in the Court of Appeals indicates that Cenco considered Illinois state law to be applicable. Cenco there argued that the District Court's instruction on contributory negligence allegedly was refuted by *Cereal Byproducts, supra*, which Cenco contended was "[t]he one relevant Illinois decision. . . ." (Cenco br. 46). Moreover, Cenco did not object to the contributory negligence instruction, or any other instruction, on the basis that it violated federal law. To the contrary, Cenco's objection to the District Court's instruction on causation and contributory negligence was based upon the contention that those instructions "contradicted *Cereal Byproducts*," an Illinois state court case. (Cenco br. 47). In summing up its criticism of the entirety of the relevant District Court instructions, Cenco, in its principal Court of Appeals brief, stated:

> "The *National Surety-Cereal Byproducts* standard, in light of both precedent and logic, should have governed the district court's instructions." (Cenco br. 50).

Both the *National Surety* and *Cereal Byproducts* cases, *supra*, were state common law cases.

Even if petitioner had raised the issue of federal common law below, its contention that this is an appropriate case for creation of federal common law would be without merit. The refusal of the Court of Appeals to undertake the creation of

federal common law is consistent with precedents of this Court.[7] Cenco's attempt to recover from its auditor does not involve any clearly expressed federal interest or policy; nor does it touch any federal program. There is no federal law, policy or program which requires that a fraudulent corporation be permitted to shift the entire responsibility for its fraud to its auditors. Congress has seen no need for federal legislation to govern damage cases between auditors and their clients. Negligence, breach of contract and fraud are traditional state common law issues. State courts have applied the common law in those areas throughout this country's history, and they have developed considerable expertise therein. Moreover, federal common law does not control controversies solely between private parties, which do not involve a conflict between state law and federal policy. *Wallis* v. *Pan American Petroleum Corp.*, 384 U. S. 63 (1966); *Miree* v. *DeKalb County, supra.* Cenco's attempt to demonstrate that such a conflict exists is conclusory and unpersuasive.

In *Miree* v. *DeKalb County, supra,* petitioners were survivors of deceased passengers on a plane which crashed at an airport. Petitioners claimed that they were third-party beneficiaries of a contract between the airport and the Federal Aviation Authority and that the airport had breached the contract by maintaining a garbage dump adjacent to the airport, attracting birds which were ingested into the jet engines, thereby causing the crash. Petitioners' claims would have been barred under Georgia law. The Court of Appeals had held that a suit would lie under federal common law. In reversing the Court of Appeals, this Court relied on the fact that "no federal interests" were at stake, adding:

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[7] Since Cenco has not cited any existing body of federal common law controlling controversies between auditors and their corporate clients, the Court of Appeals would have been required to create federal common law, rather than apply existing federal law.

> "...[I]n this case, the resolution of petitioners' breach-of-contract claim against respondent will have no direct effect upon the United States or its Treasury ... [W]e see no reason for concluding that these operations [of the United States] would be burdened or subjected to uncertainty for variant state-law interpretations regarding whether those with whom the United States contracts might be sued by third-party beneficiaries to the contracts. Since only the rights of private litigants are at issue here, we find the *Clearfield Trust* rationale inapplicable."

433 U. S. at 29-30.

In *Wallis* v. *Pan American Petroleum Corp.*, 384 U. S. 63 (1966), this Court discussed the nature of a federal interest which would be sufficient to invoke the application of federal common law. It stated:

> "In deciding whether rules of federal common law should be fashioned, normally the guiding principle is that a significant conflict between some federal policy or interest and the use of state law in the premises must first be shown. It is by no means enough that, as we may assume, Congress could under the Constitution readily enact a complete code of law governing transactions in federal mineral leases among private parties. Whether latent federal power should be exercised to displace state law is primarily a decision for Congress."

384 U. S. at 68.

In the instant case, the mere fact that federal securities laws require public companies to have independent audits falls far short of establishing existence of a congressional policy in conflict with the decision of the Court of Appeals. Indeed, if one were to attempt to derive a federal policy governing auditor-client private damage litigation from the federal securities laws, which are silent on the subject, such a policy would be consistent with the Court of Appeals' refusal to permit a

corporation to recover for its own fraud from its auditors. See the Foreign Corrupt Practices Act of 1977, Pub. L. 95-213, amending the Securities Exchange Act of 1934. (Resp. App. E). In that amendment, Congress placed the burden upon the *issuer (i.e.,* the client) to maintain accurate accounting records, internal accounting controls and an accurate record of assets.

Furthermore, established federal policy denies one violator of the federal securities laws the right to be indemnified by another alleged wrongdoer, on the basis that one who is guilty of serious wrongdoing should not be permitted to escape loss by shifting his entire responsibility to another party. *Heizer Corp.* v. *Ross,* 601 F. 2d 330 (7th Cir. 1979). The Court of Appeals herein cited *Heizer* on this very subject and noted that Cenco was an admitted wrongdoer attempting to shift its entire responsibility to its auditor. (Pet. App. A15). If Cenco's objections to the jury instructions had been upheld, Cenco not only could have retained the fruits of its fraud but it also could have recovered against the auditors it deceived. *That* would have conflicted with public policy, as enunciated in *Heizer.*

The decisions of this Court which Cenco contends required the Court of Appeals to proceed under federal common law are inapplicable. In *Clearfield Trust Co.* v. *United States,* 318 U. S. 363 (1943), unlike the instant case, the United States was a party, and the Government's own rights and duties on its commercial paper were in issue. In *Banco Nacional de Cuba* v. *Sabbatino,* 376 U. S. 398 (1964) and *Illinois* v. *City of Milwaukee,* 406 U. S. 91 (1972), the subject matter of the suits involved such areas of the law as international relations and interstate navigable waters, which have been traditionally governed by a body of federal common law.

In considering the applicability of federal common law, this Court said in its recent opinion in *Texas Industries, Inc.* v. *Radcliff Materials, Inc.,* 451 U. S. 630, 641 (1981):

> "... absent some congressional authorization to formulate substantive rules of decision, federal common law exists only in such narrow areas as those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of states or our relations with foreign nations, and admiralty cases."

Petitioner cites several cases which it incorrectly claims represent application of federal common law. However, those cases involved interpretation of language in federal statutes, not application of federal common law.

Jackson Transit Authority v. *Local Division 1285, Amalgamated Transit Union*, ____ U.S. ____, 50 U.S.L.W. 4603 (June 7, 1982), did not involve creation or application of federal common law. The plaintiff's claim in *Jackson Transit* arose under a federal statute. Nevertheless, this Court, reversing the court below, held that the statute's legislative history demonstrated that Congress intended the contracts in issue to be governed by *state law* applied in state courts. Thus, *Jackson Transit Authority* is contrary to petitioner's position. With respect to petitioner's argument that *Jackson Transit* shows that "[t]he appropriateness of applying federal common law usually turns on congressional intent" (Pet. 19), we note that there was no showing below and there is no showing in Cenco's petition that Congress intended to have federal common law determine negligence, breach of contract and fraud issues in damages litigation between auditors and clients.

In *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U. S. 11 (1979), cited by Cenco, the issue was whether a stockholder of a mortgage trust had causes of action under the federal Investment Advisers Act of 1940 for injunctive and damage relief. This Court held that because the contract in issue was voidable under the terms of the statute, plaintiffs were entitled to injunctive relief or rescission, but were not entitled to sue for damages in the absence of an express provision by Congress that damages were available. The Court stated:

> "But the mere fact that the statute was designed to protect advisers' clients does not require the implication of a private cause of action for damages on their behalf."

444 U. S. at 24. Thus, *Transamerica* involved interpretation of a federal statute, not federal common law.

Similarly, there was no issue of federal common law in *Machinists* v. *Central Airlines, Inc.*, 372 U. S. 682 (1963); *Norfolk & Western R. Co.* v. *Nemitz*, 404 U. S. 37 (1971); and *Mills* v. *Electric Auto-Lite Co.*, 396 U. S. 375 (1970). These cases involved only the interpretation of federal statutes which specifically provided for the contracts under consideration. Cenco's contention that the above cases "applied federal common law to the enforcement of contracts contemplated by federal statutes" (Pet. 21) is based on a misreading of those cases. The Court there applied the *statutes*, not common law, to the contracts. To the extent that contracts were involved in those cases, their enforceability or non-enforceability was based on what *the statutes, not federal common law*, said about them. In the instant case, the statutes and rules relied on by Cenco do not even mention contractual relations between an auditor and its client.[8] The mere fact that a federal statute requires that there be audits does not mean that a negligence, breach of contract or fraud lawsuit for damages between two private parties regarding a particular audit contract must be determined under federal common law. That is the teaching of this Court's opinion in *Miree, supra.* See also *Transamerica Mortgage Advisors, supra* and *Wallis, supra.*

Another ground urged by petitioner for creation of a rule of federal common law is the alleged existence of a need for interstitial lawmaking within a complex of federal regulation. (Pet. 21). Petitioner cites *United States* v. *Little Lake Misere Land Co.*, 412 U. S. 580 (1973). In that case, there was a

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[8] SEC Regulation S-X, SEC Rule 14a-3, and other regulations promulgated under Section 13 of the Securities Exchange Act of 1934. (Pet. 21, App. G).

collision between provisions in a federal statute and in a Louisiana statute concerning federal land acquisitions. This Court held that federal courts could determine the choice of law, since the federal government was a party and the state law was plainly hostile to the interests of the United States. In holding that federal law controlled, the Court limited interstitial lawmaking to "an area comprising issues substantially related to an established program of government operation." (412 U. S. at 593). In the instant case, there is no "established program of government operation" concerning private damage claims between auditor and client. Government operations are not in issue. Further, in the instant case, the United States is not a party, and there is not any issue of conflict between a federal statute and a state statute.

The Supreme Court has declined to engage in interstitial legislation where congressional policy to guide the Court was not evident. See *Transamerica Mortgage Advisors, supra,* in which this Court declined to create a federal right to damages under the Investment Advisers Act. In *Texas Industries, Inc.* v. *Radcliff Materials, Inc., supra,* this Court declined to engage in interstitial judicial lawmaking to create a federal common law right to contribution under the federal antitrust laws, because Congress had not indicated a policy in favor of contribution. Quoting from its decision in *Northwest Airlines, Inc.* v. *Transport Workers,* 451 U. S. 77, 97 (1981), this Court said:

> "In almost any statutory scheme, there may be the need for judicial interpretation of ambiguous or incomplete provisions. But the authority to construe a statute is fundamentally different from the authority to fashion a new rule or to provide a new remedy which Congress has decided not to adopt."

451 U. S. at 646.

United States v. *Standard Oil Co.,* 332 U. S. 301 (1947), stands for the same principle. There, the United States sued to recover from the owner and driver of a truck which injured a soldier the cost of hospitalization and the value of the loss of the soldier's services. This Court held that although the

government-soldier relationship was the creation of federal law, the right to recover such costs as damages had not been covered by legislation. This Court stated:

> "... exercise of judicial power to establish the new liability ... would be intruding within a field properly within Congress' control and as to a matter concerning which it had seen fit to take no action.... Until [Congress] acts to establish liability, this court and others should withhold creative touch."

332 U. S. at 316-17. Applying the lesson of *Standard Oil*, we note that during the 49 years since enactment of the securities laws, Congress has seen fit not to enact legislation governing the issues involved in the instant case. The silence of Congress in such circumstances is not a delegation of legislative responsibility to the federal courts. See *Texas Industries, supra.*

Petitioner contends, without foundation, that the accounting and reporting provisions of the federal securities laws require that federal common law be created to govern liability in private negligence, breach of contract and fraud damage litigation between auditor and client, in order to achieve uniformity. Congress has not recognized any such requirement. Moreover, this Court has rejected uniformity as a controlling criterion for determining the need for federal common law. As stated in *Wilson* v. *Omaha Indian Tribe*, 442 U. S. 653 (1979):

> "We should not accept 'generalized pleas for uniformity as substitutes for concrete evidence that adopting state law would adversely affect [federal interests].' *United States* v. *Kimbell Foods, Inc., supra,* [440 U.S. 715 at 730 (1979)]."

442 U. S. at 673. This principle in *Wilson* was followed in *Powers* v. *U. S. Postal Service*, 671 F. 2d 1041, 1045 (7th Cir. 1982).[9]

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[9] In any event, creation of federal common law in this case would not result in uniformity, since within each state, issues in private auditor-client damage cases, which presently are governed by a single body of law, would then be governed by two different bodies of law, one for companies Cenco describes as "public companies" and one for all other companies.

While Cenco's contention that the Court of Appeals should have created federal common law in this case is without merit, the court would have reached the same decision even if it had undertaken "so ambitious an exercise of judicial creativity." (Pet. App. A4). The court's reasoning in determining Illinois law was based upon application of general, "underlying objectives of tort liability," including principles of deterrence and compensation (Pet. App. A9-12), and not a narrow view of those principles in a particular jurisdiction. (Pet. App. A9).[10] Furthermore, the Court of Appeals commented that if federal common law were applied, it would be adverse to Cenco, since *Heizer Corp.* v. *Ross, supra,* denies indemnity under the federal securities laws to an admitted wrongdoer, such as Cenco. (Pet. App. A15).

Cenco appears to argue that even if state law applied to the issues in this case, the Court of Appeals did not correctly determine that the law of Illinois, rather than of some other state, should be applied. (Pet. 18, n. 13). Cenco never raised any issue in the District Court or the Court of Appeals concerning choice of law. The Court of Appeals was clearly correct in applying Illinois law. Cenco's principal place of business and its headquarters were in Illinois, and the Seidman office which was in charge of Cenco's audits was Seidman's

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[10] On the subject of compensation, it should be noted that no part of any recovery by Cenco in this case would benefit any stockholder who had been injured by the Cenco fraud. It would go, as a windfall, entirely to Cenco's sole present stockholder, Manor Care, Inc., which on July 22, 1981 absorbed Cenco by merger. (Pet. ii). Manor Care's interest in Cenco was acquired after the fraud was disclosed and after the trial of the case; so it is not entitled to compensation either directly or indirectly as a stockholder of Cenco. As the Court of Appeals stated, "[T]he shareholders who bought after the fraud was unmasked lost nothing." (Pet. App. A10). The shareholders who claimed they were injured by the fraud recovered 18.5 million dollars in settlements from Cenco, Cenco's former officers and directors and Seidman, of which Seidman paid 3.5 million dollars (Pet. 7; Pet. App. A3,10).

many of Cenco's fraudulent acts took place there. It is not surprising that Cenco relegated its state conflict of law comment to a single sentence in a footnote and refrained from developing an argument on the subject.[11]

CONCLUSION

The questions presented by Cenco for review violate Supreme Court Rules 21.1(a) and 21.5; so there are no properly presented questions for review in Cenco's petition.

The issues in this case have been determined by the courts below without dissent. No question of federal law has been presented by petitioner. There are no previous federal or state court decisions on the issues in the case and no conflict among the courts to be resolved. The controversy is between two private parties under the common law of negligence, breach of contract and fraud, areas in which state law traditionally governs. No federal statute or rule is claimed to have been violated. The Court of Appeals correctly applied Illinois law, and petitioner does not contend that the Court of Appeals misinterpreted Illinois law. Petitioner's contention that the lower courts should have created federal common law is untimely and without merit.

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[11] Because the decision of the Court of Appeals is limited to the particular facts and circumstances in this private controversy under Illinois law and will have no effect on other litigants in other circumstances, the Court of Appeals decision is merely episodic. Thus, Cenco has not raised an important question, let alone an important question of federal law. See Stern and Gressman, *Supreme Court Practice, supra,* at 284-85.

For the foregoing reasons, Cenco's petition for certiorari should be denied.

Respectfully submitted,

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[STATEMENT ON AUDITING STANDARDS]

[110].**06** Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Accordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively. In the case of fidelity bonds, protection is afforded not only by the indemnification for discovered defalcations but also by the possible deterrent effect upon employees; the presence of fidelity bonds, however, should not affect the scope of the auditor's examination.

• • •

Limitations

[320].**34** There are inherent limitations that should be recognized in considering the potential effectiveness of any system of accounting control. In the performance of most control procedures, there are possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction, or fatigue. Furthermore, procedures whose effectiveness depends on segre-

gation of duties obviously can be circumvented by collusion. Similarly, procedures designed to assure the execution and recording of transactions in accordance with management's authorizations may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.

JURY INSTRUCTION OF UNITED STATES DISTRICT COURT

[5788] Now, a corporation or a partnership cannot act for itself, they may only act through their agents, and agents of a corporation are the officers and employees. Agents of a partnership are the partners and employees, and corporations and partnerships are legally responsible for those acts or omissions of agents made or performed within the scope of their employment. To be acting within the scope of employment, the agent first must have intended [5789] that the act must produce some benefit to the corporation or partnership; second, the agent must have been acting within the scope of authority. An act was within the agent's authority if it was directly related to the performance of the type of duties that the employee had the general authority to perform, or if outsiders could reasonably assume that the agent had the authority to perform the act, judging from the position with the company, the *responsibility previously entrusted to the agent, and the* circumstances surrounding past conduct.

RECEIVED
Jul 10 1981
H. Stuart Cunningham
United States District Court

IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

IN RE CENCO INCORPORATED SECURITIES LITIGATION.

ROBERT HELFAND, et al.,

Plaintiffs,

v.

CENCO, INC., a Delaware corporation,

Cross-Claimant and Third-Party Plaintiff,

v.

SEIDMAN & SEIDMAN,

Cross-Defendant.

MDL Docket No. 291

No. 75 C 2227
A Consolidated Cause

Honorable
John P. Crowley
Presiding Judge

NOTICE OF APPEAL OF CENCO INCORPORATED

Notice is hereby given that CENCO INCORPORATED, cross-claimant and third-party plaintiff named above, hereby appeals to the United States Court of Appeals for the Seventh Circuit from the final judgment of the District Court dismissing Cenco's claims against Seidman & Seidman and, without limitation of the foregoing, these additional orders and rulings of the District Court: the order entered May 11, 1980 dismissing Cenco's claim for contribution from Seidman & Seidman; the order entered June 10, 1981 denying Cenco's motions for judgment notwithstanding the verdict and/or a new trial; the

order entered June 10, 1981 awarding Seidman & Seidman costs; the order entered June 30, 1981 awarding Seidman & Seidman costs; the order entered June 30, 1981 awarding Seidman & Seidman costs in the amount of $76,617.10; and rulings at trial refusing jury instructions proffered by Cenco, granting jury instructions over objections by Cenco, denying Cenco's motion for directed verdict on its claims against Seidman & Seidman, and entering directed verdict against Cenco on its claims against Seidman & Seidman for conspiracy and aiding and abetting the conspiracy.

Cenco will present the following questions for review by the Court of Appeals and other questions related to them:

(1) Whether the District Court improperly dismissed Cenco's claim for contribution from Seidman & Seidman for amounts which Cenco paid in settlement;

(2) Whether the District Court improperly instructed the jury on the duties, liabilities, and defenses of a certified public accountant, Seidman & Seidman, to its client, Cenco;

(3) Whether the District Court improperly took from the jury consideration of whether Seidman & Seidman conspired with, or aided and abetted a conspiracy of, former Cenco officers and employees to inflate Cenco's inventories and to conceal that inflation;

(4) Whether the District Court improperly disallowed reading of the Magdovitz Deposition.

(5) Whether the District Court improperly refused to strike the testimony of Irving Duchan, the expert witness for Seidman & Seidman.

(6) Whether the District Court improperly allowed Seidman & Seidman to recover costs; and,

(7) Whether the District Court allowed improper amounts of costs to Seidman & Seidman.

DATE: July 10, 1981

Respectfully submitted,

/s/ DONALD E. SCOTT
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PUBLIC LAW 95-213 [S. 305]; DEC. 19, 1977

FOREIGN CORRUPT PRACTICES ACT OF 1977

An Act to amend the Securities Exchange Act of 1934 to make it unlawful for an issuer of securities registered pursuant to section 12 of such Act or an issuer required to file reports pursuant to section 15(d) of such Act to make certain payments to foreign officials and other foreign persons, to require such issuers to maintain accurate records, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—FOREIGN CORRUPT PRACTICES

SHORT TITLE

SEC. 101. This title may be cited as the "Foreign Corrupt Practices Act of 1977".

ACCOUNTING STANDARDS

SEC. 102. Section 13(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(b)) is amended by inserting "(1)" after "(b)" and by adding at the end thereof the following:

"(2) Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to section 15(d) of this title shall—

"(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

"(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—

"(i) transactions are executed in accordance with management's general and specific authorization;

"(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

"(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

"(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

* * *

CERTIFICATE OF SERVICE

Samuel Weisbard, a member of the Bar of this Court and counsel of record for respondent, Seidman & Seidman, certifies that five (5) copies of the foregoing "Seidman & Seidman's Brief in Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit" were served by hand upon counsel of record for Cenco Incorporated, Fred H. Bartlit, Jr., Esq., Kirkland & Ellis, 200 East Randolph Drive, Chicago, Illinois 60601, this 28th day of August, 1982. All parties required to be served have thus been served.

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Samuel Weisbard